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CH. 14 FOREIGN INVESTMENT INTEREST OFFSET

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14.1 IN GENERAL

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a. The Foreign Investment Interest Offset

Revenue and Taxation Code (RTC) §24344(c) provides that interest expense incurred for purposes of foreign investments may offset dividends deductible under RTC §24411. The purpose of the foreign investment interest offset is to offset the water's-edge group's RTC §24411 dividend deduction by interest expense attributable to foreign investments. The underlying theory being one of "matching" income and expense. In other words, interest expense incurred to carry an investment that generates income that is not included in the measure of tax should be "matched" with the nontaxable income, and should be excluded.

Before determining the foreign investment interest offset, the RTC §24411 dividend deduction should be determined or tested. RTC §24344, which allocates the deduction of interest, is controlled by RTC §24425, which prohibits the deduction of any amount allocated to income that is excluded from the measure of tax. (*Appeal of Signal International*, 66-SBE-018, January 4, 1966.) If the water's-edge group does not claim an RTC §24411 dividend deduction, then there would be no foreign investment interest offset.

The foreign investment interest offset is limited to the LESSER of:

1. Interest expense attributable to foreign investments.
2. The water's-edge group's RTC §24411 dividend deduction.

Total interest expense paid or incurred by the water's-edge group is specifically allocated or assigned by formula between foreign and domestic investments. The total interest expense attributable to foreign investment is subject to the foreign investment interest offset, which is a direct adjustment to net income after state adjustments. <u>It is not taken into account</u> when computing the water's-edge group's regular interest offset under RTC §24344(b). (California Code of Regulations (CCR) §24344(c)(3)(B).)

Interest expense, subject to the foreign investment interest offset, is equal to the sum of: interest expense allocated to specific foreign investment; PLUS unassigned interest expense allocated to foreign investment. The computation of the foreign investment interest offset is a two-step process:

- First, the taxpayer determines if any interest is specifically assignable to either domestic or foreign investments.

- Second, any remaining interest not specifically assignable is allocated between domestic and foreign investments based on a ratio. (CCR §24344(c)(3)(C).) The ratio is the group's foreign investments to total assets:

Pool of <u>Unassigned Foreign Investment</u> Interest Expense

Unassigned Interest Expense	X	Unassigned Total Assets	=	Assigned to Foreign Investment

The foreign investment interest offset is the sum of the amount of interest specifically assignable to foreign investment plus the amount allocated to foreign investment. However, the amount of the offset may not exceed the RTC §24411 dividend deduction.

For taxable years beginning on or after January 1, 1997, the foreign investment interest offset as calculated above should be multiplied by the same percentage that was used to determine the dividend deduction under RTC §24411, usually 75%. (RTC §24344(c)(2).)

See Exhibit 14 for an overview of the foreign investment interest offset.

b. Computation On A Combined Basis

The interest offset is computed on a combined basis, not a separate entity basis. Authority for computing the foreign investment interest offset on a combined basis can be found in the regulatory requirement to eliminate intercompany accounts of interest and assets from the offset computation. (CCR §24344(c)(2)(B)(iii) and §24344(c)(2)(C)(iii).) The reason for the eliminations is to avoid double counting that would otherwise occur in a combined offset computation. The fact that the regulation requires these adjustments clearly indicates a requirement to compute the offset on a combined basis. If the offset were required to be computed on a separate entity basis, there would be no reason to make the intercompany account adjustments.

Additional authority can be found in the California Supreme Court's decision in *Pacific Telephone and Telegraph Co. v. Franchise Tax Board (FTB)*, 102 Cal. Rptr. 782 (1972). In this case, the FTB computed the interest offset adjustment (RTC §24344(b)) on a group basis. The taxpayer argued that the computation should be done on a separate entity basis. The court found that FTB's computation of the offset on a group basis was supported by the statute and rejected the single entity argument made by the taxpayer. The court's reasoning is equally applicable to the foreign investment interest offset provision.

c. Intercompany Adjustments

In preparing a water's-edge combined report, intercompany accounts of assets, liabilities, equities, income, costs and expenses may be required to be eliminated in whole or in part to properly reflect net income and apportionment factors in a combined report. For partially included entities, intercompany transactions are eliminated only to the extent of the amounts actually included in the water's-edge combined report.

In general, the elimination of intercompany accounts of expense, assets and equities for purposes of RTC §24344(c) will not increase or decrease the net income that would otherwise be taken into account for any entity, <u>except</u> as provided under RTC §24344(c). (CCR §25110(e)(1).) The purpose of the elimination is to avoid taking into account the subject item more than once in a combined report.

The following example shows that while a Controlled Foreign Corporation (CFC) and United States (US) entity may have intercompany transactions, the intercompany elimination is limited by the CFC's partial inclusion ratio.

Example:

P and S are affiliated corporations included in the water's-edge combined report under RTC §25110(a)(3) and RTC §25110(a)(6). (RTC §25110(a)(3), formerly RTC §25110(a)(1). RTC §25110(a)(6), formerly RTC §25110(a)(7).) P has net income of $500. S has net income of $300 and a ratio of Subpart F income to earnings and profits (E&P) for the taxable year of 1/3. P incurs $30 of interest expense paid to S, of which $10 ($30 x 1/3) is considered an intercompany account. It is determined that $10 of P's interest expense is an intercompany account to be eliminated for purposes of calculating the foreign investment interest offset. (See Chapter 17, Water's-Edge Manual for a detailed discussion of the proper treatment of intercompany transactions in the water's-edge combined report.)

The combined net income of P and S is determined as follows.

<u>Combined Net Income:</u>

	Corp P & S
Net income of P	$500
Net income of S ($300 multiplied by 1/3)	$100
Combined net income <u>before</u> offset	$600

<u>Combined Net Income With Intercompany Adjustment</u>:

	Corp P	Corp S	Total
Net income	$500	$100	
Intercompany interest adjustment	+ 10	- 10	
Net income	$510	$ 90	= $600

For purposes of determining the interest offset, $10 of P's interest expense is considered to be intercompany and $10 S's interest income is considered to be intercompany. These amounts are eliminated in the computation of interest offset. However, note that the combined net income is not increased or decreased by intercompany interest expense.

d. Interplay With RTC §24344(b)

If the water's-edge group is not allowed a RTC §24411 foreign dividend deduction, then there is no foreign investment interest offset because the foreign investment interest offset cannot exceed the RTC §24411 deduction. However, the total interest expense incurred or paid remains subject to the regular interest offset under RTC §24344(b).

If the water's-edge group is allowed a RTC §24411 foreign dividend deduction, then:

Total:	Interest expense paid or incurred by water's-edge group.
Less:	Foreign investment interest offset under RTC §24344(c).
Equals:	Excess interest, if any, is subject to RTC §24344(b).

Any excess of total interest expense incurred or paid by the water's-edge group over the foreign investment interest offset is subject to the interest offset under RTC §24344(b). The total interest expense used in the RTC §24344(b) offset calculation must be reduced by the foreign investment interest offset.

e. Forms

The water's-edge group foreign investment interest offset appears in the following forms:

FTB 2424:	Water’s-Edge Foreign Investment Interest Offset.
Schedule R:	Line 1b, Water's-edge foreign investment interest offset from Form FTB 2424, line 17.

14.2 FORM FTB 2424

CONTENTS:

a. **Form FTB 2424, Line 1 - RTC §24411 Dividend Deduction**
b. **Form FTB 2424, Line 2 - Total Interest Expense**
c. **Form FTB 2424, Lines 3 and 4, Specifically Assigned Interest**
d. **Form FTB 2424, Line 5 - Unassigned Interest Expense**
e. **Form FTB 2424, Line 11 - Unassigned Foreign Investment**
f. **Form FTB 2424, Line 12 – Unassigned Total Assets**
g. **Form FTB 2424, Lines 13, 14, 15, 16 and 17**

a. Form FTB 2424, Line 1 - RTC §24411 Dividend Deduction

The RTC §24411 dividend deduction is the amount determined on Schedule H (100W), Part III, line 7, column (g); or Form 100S, Side 1, Line 10. If there is no RTC §24411 dividend deduction claimed or allowed, then there will be no foreign investment interest offset. The foreign investment interest offset is limited to the LESSER of interest expense attributable to foreign investments, OR the RTC §24411 dividend deduction allowed. It may not exceed the total RTC §24411 dividend deduction. (CCR §24344(c)(3)(A).)

b. Form FTB 2424, Line 2 - Total Interest Expense

Total interest expense includes all interest expense incurred or paid within the taxable year by any bank or corporation to the extent the entity is included in the water's-edge combined report. (CCR §24344(c)(2)(B).) Total interest expense should reconcile to the financial statements of the entities included in the combined report and to their books and records. The computation is done on an aggregate basis for the entire water's-edge group.

Total interest includes:

1. All interest expense paid or incurred by entities included 100%, which includes the following entities:

- US incorporated banks and corporations, excluding corporations making an election under Internal Revenue Code (IRC) §936, that are owned more than 50% by the same interests.
- Domestic International Sales Corporations, Foreign Sales Corporation and Export Trade Corporations.
- Any corporation, regardless of where incorporated, whose average property, payroll and sales in the US are 20% or more. (This can include corporations making an election under IRC §936.)

(Chapter 2, Water's-Edge Manual contains a detailed discussion of the entities included 100% in the water's-edge combined report.)

2. A portion of the interest expense paid or incurred by those entities that are partially included in the water's-edge combined report. A CFC's total interest expense will be included to the extent of the ratio of their Subpart F income to their current year E&P. (CCR §24344(c)(2)(B)(ii)(II).)

Example:

Corp F (a CFC) is included in the combined report under RTC §25110(a)(6). F's Subpart F income is $1,000 and its current year E&P is $4,000, resulting in a partial inclusion ratio of 1/4. Only 1/4 of F's total interest expense of $400 is included in the water's-edge group foreign investment interest offset computation. ($400 x 1/4 = $100 interest expense included in the combined report.)

Foreign entities with income attributable to sources within the US will include only that portion of the interest expense reflected on the books of account maintained with respect to the US activities, (i.e., the interest expense that is included in the computation of net income subject to inclusion in the combined report.) (CCR §24344(c)(2)(B)(ii)(I).)

3. Remember, intercompany eliminations of any interest income or interest expense between members of the water's-edge group will be necessary.

c. Form FTB 2424, Lines 3 and 4, Specifically Assigned Interest

Per CCR §24344(c)(4)(A), to be assigned to a specific asset (including investments), whether foreign or US, interest expense must meet ALL three of the following conditions:

1. The underlying indebtedness must have been specifically incurred for the purpose of purchasing, maintaining or improving the asset.

2. The proceeds of the borrowing must actually have been applied for the specified purpose.

3. The creditor can look ONLY to the specific asset as security for the payment.

Interest expense will not be considered traced to a specific asset when the motive for structuring the transaction had no economic significance. For a comparison between these requirements and the federal rules for direct assignment of interest expense, see Section 14.3, Water's-Edge Manual. When the interest is related solely (traced) to a specific asset, neither the interest nor the asset can be used in the allocation of unassigned interest expense. (CCR §24344(c)(4)(B).)

If material amounts of interest are specifically assigned to domestic property, you may want to consider the following audit steps:

- Obtain workpapers supporting the specifically assignable debt.
- Determine the original debt instrument used as a basis by the taxpayer to specifically assign interest to US assets.
- Analyze debt purpose.
- Determine whether 100% of the funds were specifically applied to purchasing, maintaining or improving the specific asset.
- Determine if the funds that were acquired for the specific asset are the only security to which the creditor can look.

If the debt does not meet all of these criteria, then the interest cannot be specifically assigned to the asset and must be included in the pool of unassigned interest.

The similarities between the California rules for specific assignment of interest and the federal rules for direct allocation on interest from Qualified Nonrecourse Indebtedness (QNI) are discussed in Section 14.3, Water's-Edge Manual.

d. Form FTB 2424, Line 5 - Unassigned Interest Expense

The total interest expense (FTB 2424, Line 2), less any interest expense specifically assigned to foreign or US investment (FTB 2424, Lines 3 and 4), is the pool of unassigned interest expense. (Unassigned interest expense is allocated to foreign investment based on the ratio of foreign investment to total assets.)

A distinction must be made between interest expense paid on debt incurred before January 1, 1988, and interest expense paid on debt incurred after January 1, 1988. Any interest expense paid on debt incurred after January 1, 1988, that relates to debt proceeds that were deposited into a “restricted account” will be excluded from the pool of unassigned interest expense.

1. Form FTB 2424, Line 6 - Unassigned Interest Expense Paid on Debt Incurred Prior to January 1, 1988

All unassigned interest expense paid on debt incurred prior to January 1, 1988, is included in the pool of unassigned interest expense and is subject to assignment by formula to foreign investment. (CCR §24344(c)(5)(B).)

2. Form FTB 2424, Line 7 - Unassigned Interest Expense Paid on Debt Incurred on or After January 1, 1988

This line includes all interest expense paid on debt incurred on or after January 1, 1988, unless the debt meets BOTH the refinancing and restricted account criteria. If both criteria are met, the interest on the debt is excluded from the pool of unassigned interest. If the debt does not meet both criteria, interest on the debt is included in the pool of unassigned interest expense.

A. Refinancing Criteria

If the majority of the debt was not used to refinance debt incurred prior to January 1, 1988, AND the debt proceeds were deposited in a “restricted account” (see below), then the interest expense is considered assigned to US investment.

However, if the majority of the debt was used to refinance debt incurred prior to January 1, 1988, or the debt arose pursuant to a line of credit or similar account or arrangement established prior to January 1, 1988, then the debt is treated as debt incurred prior to January 1, 1988. (CCR §24344(c)(5)(C).) Thus, interest on this debt is included in the pool of unassigned interest.

B. Form FTB 2424, Line 8, Restricted Accounts

If the debt proceeds were not used to refinance old debt and the debt proceeds were deposited into a "restricted account", then the interest expense is excluded from the pool of unassigned interest. It is considered assigned to US investment.

A "restricted account" is an account that precludes its use for foreign investment and which has not, in fact, been used for foreign investment. (CCR §24344(c)(4)(A).)

The following will disqualify a taxpayer from the "restricted account" relief provision:

- <u>Use of Funds (CCR §24344(c)(5)(C)(i))</u>

  If any of the funds in the restricted account are used for foreign investment, then the restricted account will be viewed as unrestricted and the interest expense will be included in the pool of unassigned interest. This will apply only for the year in which the use occurred. Thus, the unassigned interest expense related to the restricted account will be subject to assignment by formula to foreign investment for that year.

- <u>Transfer of Funds (CCR §24344(c)(5)(C)(ii))</u>

  The transfer of funds, from a restricted account to or through an unrestricted account or accounts from which proceeds are disbursed for purposes of <u>foreign investment</u> within 60 days of the transfer, will disqualify the restricted account. Thus, that interest would be included in the pool of unassigned interest for that year.

C. Form FTB 2424, Line 9 - Net Unassigned Interest Expense On Debt Incurred After January 1, 1988

Subtract the interest expense related to restricted accounts (Line 8) from the unassigned interest expense paid on debt incurred on or after January 1, 1988 (Line 7). The remaining balance is the net unassigned interest expense paid on debt incurred on or after January 1, 1988.

3. Form FTB 2424, Line 10 - Total Unassigned Interest Expense

The sum of Line 6 (unassigned interest expense paid on debt incurred prior to January 1, 1988) and Line 9 (net unassigned interest expense paid on debt incurred after January 1, 1988) results in the total pool of unassigned interest expense to be apportioned by formula. The pool of unassigned interest expense should now consist of interest expense not specifically assigned to foreign or US assets. The interest expense has not met the restricted account test.

e. Form FTB 2424, Line 11 - Unassigned Foreign Investment

Enter the amount of total unassigned foreign investment. Foreign investment is defined as stock or other equity in foreign entities, excluded from the waters-edge combined report, determined by using the federal basis rules and adjusting for accumulated E&P. None of the foreign investments to which interest expense was specifically assigned is includible here. Make any intercompany eliminations, including the equity investment in a partially included CFC based on its inclusion ratio.

Total unassigned foreign investment is computed as follows:

Total:	Foreign investment:
Less:	Any foreign investment to which interest has been specifically assigned.
Less:	Intercompany eliminations.
Equals:	Unassigned foreign investment.

1. Entities Included In Total Foreign Investment:

Total foreign investment is equal to stock (or other equity investment), regardless of when it was made, in any:

- Entity whose dividends would qualify for the water's-edge dividend deduction.

- Nonaffiliated bank or corporation that is organized outside the US. (CCR §24344(c)(2)(A).)

This calculation becomes especially difficult when there are multiple tiers of CFCs, which are partially included in the combined report.

The numerator of the foreign investment interest offset includes the foreign investment in foreign corporations directly owned by the water's-edge group whose dividends, if paid, would qualify for the RTC §24411 deduction. Per CCR §24344(c)(2)(A)(iii), only the portion of the foreign corporation's equity that is included in the denominator will be included in the numerator. Per CCR §24344(c)(2)(C)(i), only the assets of the entities included in the combined report are included in the denominator. If the assets of a partially included CFC are included in the denominator, then its equity must be excluded from the denominator since it would be considered an intercompany account. Therefore, if a CFC is partially included in the combined report, its assets will be included in the denominator. To the extent the assets are included in the denominator, the equity of that CFC will be excluded from the denominator. To the extent the equity is excluded from the denominator, the equity will be excluded from the numerator.

Example:

US Corporation is a domestic corporation fully included in the water's-edge combined report. US Corporation owns 100% of CFC1, which owns 100% of CFC2. The inclusion ratio (Subpart F income/current E&P) of CFC1 is 60% and 20% for CFC2. The foreign investment (stock basis plus accumulated E&P) in CFC1 is $100,000 and the foreign investment in CFC2 is $200,000. The amount of foreign investment for CFC1 and CFC2 included in the numerator of the foreign investment interest offset is $136,000.

CFC1 is included in the combined report based on its 60% inclusion ratio. Therefore, the foreign investment included for CFC1 would be $40,000. This is determined by taking the foreign investment of $100,000 and multiplying it by 40%, the percentage that CFC1 is excluded.

CFC2 is included in the combined report to the extent of its 20% inclusion ratio. Therefore, the foreign investment for CFC2 would be $96,000. This is determined by taking the $200,000 foreign investment and multiplying it by 80%, the percentage that CFC2 is excluded, then multiplying this number by CFC1's 60% inclusion ratio. ($200,000 x 80% x 60% = $96,000.) The foreign investment must be multiplied by CFC1's inclusion ratio since the amount included in the numerator is the foreign investment of the water's-edge group and CFC1 is only included to the extent of 60%.

2. Average Value of Foreign Investment

The unassigned foreign investment is computed at the beginning and end of the taxable year. Then, it is averaged. If the circumstances warrant it, the FTB can take an average of monthly values. (CCR §24344(c)(5)(C).)

3. Stock or Other Equity Investment Defined

Stock or other equity investment in an affiliated bank or corporation is taken into account at its adjusted federal basis, plus(minus) any increases(deficits) in E&P, but not below zero, accumulated during the period the stock was owned by an entity that is a member of the group which includes the taxpayer. (CCR §24344(c)(6)(B).) For these purposes an affiliated bank or corporation is an entity owned greater than 50%. (RTC §25110(b)(1).) Stock or other equity investment in an unaffiliated entity, (i.e., an entity owned 50% or less), is taken into account at federal tax book value, (i.e., federal adjusted basis.)

A. Federal Adjusted Basis

The federal adjusted basis in stock includes:

- Cost - IRC §1012.
- Basis Adjustments - IRC §1016. (Adjustments to stock basis are made for the amount of distributions previously made that were tax-free.)

These are the more common federal provisions which define adjusted basis, but other federal rules may also apply. Therefore, the auditor needs to analyze the taxpayer's records detailing its adjusted basis in stock investments. If the auditor is not sure of any adjustment, have the taxpayer provide the detail of the adjustment amount, the taxable year of the adjustment, and the applicable federal code section.

Note: For federal purposes, IRC §961 requires the stock basis of a CFC to be increased by undistributed amounts taxed under Subpart F, and decreased by later distributions, which are not taxed at the time of distribution because they were previously taxed.

Do not make this adjustment for state “foreign investment” purposes if the taxpayer owns more than 50% of the CFC. As explained below, for purposes of determining foreign investment, the stock in an affiliated entity is increased by the entity's E&P. If the federal stock basis adjustment made for Subpart F income is included in the foreign investment computation, there will be double counting since the total E&P (of which Subpart F income is a part) is also included in the amount of foreign investment.

B. Basis Adjusted For Accumulated E&P

CCR §24344(c)(6)(B)(i) states that the federal adjusted basis for stock in an affiliated bank or corporation is increased by the amount of E&P accumulated during the period the stock was owned by a member (including the taxpayer) of the affiliated group. Any increase in E&P, attributable to the period the stock was owned by an unaffiliated bank or corporation, is not considered in the calculation. Thus, no increase to the federal adjusted basis is made for an entity's E&P accumulated prior to ownership by a member of the affiliated group.

CCR §24344(c)(6)(B)(ii) states that the federal adjusted basis for stock in an affiliated bank or corporation will be reduced by any deficits in E&P during the period the stock was owned by any member, including the taxpayer, of the affiliated group. Any deficit, attributable to the period the stock was owned by an unaffiliated bank or corporation, is not considered in the calculation. Thus, no decrease to the federal adjusted basis is made for an entity's E&P deficits that were accumulated prior to ownership by a member of the affiliated group.

Remember, if a portion of an entity is included in the water's-edged combined report (because it has Subpart F income or income attributable to US sources), then the same portion of the taxpayer's investment in that entity's stock or other equity investment will be excluded from the computation of the taxpayer's total foreign investment. (CCR §24344(c)(2)(C)(iii).)

The information to determine the E&P of a foreign subsidiary can be found in the workpapers supporting the federal Form 1118, Foreign Tax Credit (FTC), or the foreign corporation's audited financial statements.

4. Examples of Total Foreign Investment

Example:

Corp A (a domestic corporation) bought all of Corp C's stock (a foreign corporation) from Corp B (an unaffiliated domestic corporation) in 1996 for $600,000. Corp B had owned Corp C since its inception in 1990. There has been no reportable income under Subpart F during Corp A's ownership. Corp C's accumulated E&P at the time of acquisition by Corp A was $500,000; its accumulated E&P is currently $800,000.

Corp A's foreign investment is increased by the amount of positive E&P accumulated since acquisition by Corp A. ($800,000 - $500,000 = $300,000.) Therefore, Corp A's foreign investment in Corp C is $900,000. ($600,000 + $300,000 = $900,000.)

Example:

Assume the same facts as in the first Example except that Corp A bought all of Corp C's stock from Corp D (a nonunitary affiliated domestic corporation). Since Corp D is an affiliated corporation (unity is not a factor), all of Corp C's E&P is added to Corp A's federal adjusted basis in the stock. Therefore, Corp A's foreign investment in Corp C is $1,400,000. ($600,000 + $800,000 = $1,400,000.)

Example:

Assume the same facts as the first Example except that Corp C's accumulated E&P at the time of acquisition by Corp A was $500,000; its accumulated E&P is currently a negative ($400,000.) Thus, Corp C's E&P accumulated by since acquisition by Corp A is a negative ($900,000.) The deficit adjustment cannot reduce Corp A's basis below zero. Therefore, the deficit adjustment is limited to the federal adjusted basis. Corp A's foreign investment is $0. ($600,000 - $600,000 = $0.)

Example:

Corp P, a domestic corporation with a calendar year, holds the following equity investments in foreign subsidiaries as of January 1, 2000:

Corp A (100% owned CFC)	$ 60,000
Corp B (80% owned CFC)	$ 80,000
Corp C (10% owned CFC)	$ 90,000

Corp B has Subpart F income of $5,000, and current E&P of $20,000, which results in a partial inclusion ratio of 25%. Corp A and C both have $10,000 of total E&P accumulated since acquisition by Corp P. Assume the current E&P of Corp B equals its total E&P accumulated since acquisition by Corp P.

P's end-of-year foreign investment is as follows:

Corp A ($60,000 + $10,000)	$ 70,000
Corp B [$ 80,000 + ($20,000 x 80%)] x 75%	$ 72,000
Corp C	$ 90,000
Total Foreign Investment	$232,000

For Corporation B, 25% of its income and assets are included in the water's-edge combined report. Thus, B will include 25% of its assets in the amount of unassigned total assets used in the formula to assign interest to foreign investment of the water's-edge group. Therefore, because 25% of B's underlying assets are included in total assets of the water's-edge group, 25% of Corporation P's investment in B will be eliminated from the foreign investment computation as an intercompany investment. The remaining 75% of P's investment in B will be included in the amount of foreign investment and total unassigned assets. Also, before determining the intercompany elimination, P's beginning year equity investment balance in B is increased by 80% of B's 2000 E&P, (the amount of E&P attributable to the stock owned by the water's-edge group.)

Total foreign investment also includes the stock of foreign corporations owned less than 50% (Corporation C). However, P's basis in C is not increased by its E&P because the E&P adjustment is made only for affiliated banks or corporations. Subsidiaries that are not owned more than 50% are not an affiliate per CCR §24344(c)(2)(G).

f. Form FTB 2424, Line 12 - Unassigned Total Assets

1. Total Assets

A. Total Assets Includes:

- All assets of the entities included 100% in the combined report.
- A portion of the total assets for any foreign bank/corporation included in the combined report, to the extent it has income attributable to US sources. The total assets includible is only that portion attributable to the US activities. (CCR §24344(c)(2)(C)(ii)(I).)
- A portion of the total assets for CFCs, based on their inclusion ratios. (CCR §24344(c)(2)(C)(ii)(II).)

Intercompany eliminations for stock investment in a member of the water's-edge group are made to the extent the underlying assets are included in the combined report. (CCR §24344(c)(2)(C)(iii).) All assets are included in total assets. No distinction is made between business and nonbusiness assets. (CCR §24344(c)(2)(C)(iv).)

B. Computation Of Total Assets

Federal tax book value of all assets, other than stock or other equity investment:

Plus:	Total unassigned foreign investments.
Plus:	Stock or other equity investment in a nonunitary domestic affiliate.
Less:	Assets to which interest expense has been specifically assigned.
Less:	Intercompany asset accounts between members of the water's-edge group to the extent included in the combined report.
Equals:	Total Assets.

2. Asset Values

All assets, other than stock in an affiliated bank or corporation, are taken into account at federal tax book value, which is computed as follows. (CCR §24344(c)(6)(A).)

Original cost for federal tax purposes:

Less:	Allowed depreciation, amortization or depletion.
Equals:	Federal tax book value. (CCR §24344(c)(6)(A).)

Stock or other equity investment in an affiliated bank or corporation is taken into account at an adjusted federal basis plus/minus any increases/deficits in E&P, but not below zero.

The value of assets is computed using an average of the values at the beginning and end of the taxable year. (CCR §24344(c)(6)(C).) The FTB may permit or require the averaging of monthly values during the taxable year to properly reflect the average value of the assets.

3. Intercompany Investment Account Elimination

Intercompany stock investment accounts in banks or corporations included 100% in a combined report are eliminated in their entirety. (CCR §25110(e)(4).) Intercompany stock investment accounts in banks or corporations partially included in a combined report are eliminated in the proportion or to the extent that the corresponding account of the affiliated bank or corporation is taken into account in the combined report under RTC §§25110(a)(4) or (6). (CCR §25110(e)(5).)

Be careful not to make double eliminations. If the records or financial statements used as the starting point for the computation already have made intercompany eliminations, do not duplicate the elimination.

Example:

Corporation V (a domestic corporation) holds the following equity investments before intercompany eliminations:

Corp W (100% owned domestic corporation)	$100,000
Corp X (100% owned domestic corporation)	$ 70,000
Corp Y (100% owned CFC)	$300,000
Corp Z (5% ownership in foreign corporation)	$200,000
Total Investment	$670,000
Intercompany Elimination:	
Corp W	($100,000)
Corp X	($ 70,000)
Corp Y (CFC 10% Inclusion; $300,000 x 10% = $30,000 Intercompany)	($ 30,000)
Intercompany Elimination	($200,000)
Total Investment	$ 670,000
Less Intercompany Elimination	($200,000)
Total Investment After Elimination	$ 470,000

Note: 10% of Y's income and factors is included in the combined report and none of Z's income and factors is included. Therefore, the investment amounts are not eliminated to the extent the entities are not included in the combined report. 10% of Y's assets are included in total assets.

g. Form FTB 2424, Lines 13, 14, 15, 16 and 17

These lines are mathematical computations. Once you have determined the values for Lines 1-12, Lines 13, 14, 15, 16 and 17 can be completed.

14.3 OVERVIEW – FEDERAL LAW

The purpose of this section is to give a brief overview of the federal sections that involve the allocation and apportionment of interest. These sections are very complex and the intention here is to provide some general background. California's foreign investment interest offset rules are patterned after the federal rules used to attribute interest to foreign sources for purposes of the FTC computation. Therefore, some of the information needed to compute the foreign investment interest offset should have been calculated for federal FTC purposes.

For federal purposes, there are detailed rules covering the allocation and apportionment of interest. For domestic corporations the importance of allocating and apportioning deductions is that it effects the FTC limitation. (IRC §904(a) and §904(d).) The FTC amount a US taxpayer can use to offset its US tax liability can be limited. The formula for the limitation is as follows:

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{Pre-Credit US Tax} = \text{FTC Limitation}$$

Taxpayers have long recognized that if expenses are allocated against US source income instead of foreign source income, their FTC limitation will increase. The significance of allocating and apportioning expenses is obvious. Although the basic concept is straightforward, the IRC sets forth very complex rules on how the final figures are computed. For instance, separate FTC limitations have to be computed for specific sources and categories of income or "baskets of income." Although the statutory provision for allocating and apportioning interest expense is IRC §864(e), the regulations are numbered TR §1.861-9T through TR §1.861-13T.

The IRS defines any expense that is deductible under IRC §163, including original issue discount, as constituting interest for allocation and apportionment purposes. (TR §1.861-9T(a).) The temporary TRs restate the principle that money is fungible. "The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in TR §861-10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes." (TR §1.861-9T(a).)

However, in the case of qualified nonrecourse indebtedness (QNI), the deduction for interest is considered DIRECTLY ALLOCABLE SOLELY TO the gross income generated by property that was acquired, constructed or improved with the proceeds of the indebtedness. (TR §1.861-10T(b).) The California specific assignment requirements were patterned after the federal direct allocation rules that were in TR §1.861-8(e), as it existed prior to 1988. Since that time, the federal QNI rules were modified and moved to TR §1.861-10T. Although the criteria for specific allocation of interest, under CCR §24344(c)(4), are still similar to the federal QNI rules, the rules are not exactly the same.

Federal law contains several requirements that are not applicable for California. If indebtedness qualifies as QNI for federal purposes, then it probably meets the California requirements for specific allocation. However, if interest expense does not qualify as QNI, it does not necessarily mean that it will not meet the California criteria for direct allocation. If interest expense is specifically allocated for California purposes, there should be documentation to substantiate that the California criteria was met.

Indebtedness must possess the following five characteristics to be classified as QNI for federal purposes:

1. The purpose of the QNI must be to purchase, construct or improve identified property that is depreciable real or tangible personal property with a useful life of more than 1 year or amortizable intangible personal property with a useful life of more than 1 year.

2. The proceeds must be actually applied to purchase, construct or improve the property.

3. Creditors can look only to the identified property as security for interest and principal.

4. The cash flow from the property in all years is reasonably expected to cover interest, original issue discount and principal.

5. The loan agreement restricts the disposal or use of the property consistent with #3 and #4, above.

TR §1.861-10T(b)(4) lists the following six exceptions whereby interest expense is NOT QNI, transactions that:

- Lack economic significance (facts and circumstances test).
- Involve cross collateralization.
- Involve credit enhancement.
- Involve the purchase of inventory.

- Involve the purchase of any financial asset, including stock in a corporation, an interest in a partnership or a trust, or the debt obligation of any obligor.
- Involves interest expense that constitutes qualified residence interest as defined in IRC §163(h).

For the California specifically assigned interest, the similarities between the California rules for specific assignment of interest and the federal rules for direct allocation on interest from QNI. The federal Form 1118, Schedule H, Part II, Lines 1b and 1c, provides a breakdown of specifically assigned assets and interest expense. If needed, the workpapers supporting the allocation of interest expense for purposes of the federal Form 1118, can be obtained. The specifically assigned interest will also appear on federal Form 1118, Schedule A, column 9(d). Keep in mind that there are differences between the state and federal requirements for specifically assigned interest.

For federal purposes the apportionment of interest expense to foreign sources is accomplished by formula:

$$\frac{\text{Asset Values in Given Category-Basket}}{\text{Total Assets in a Given Category-Basket}} \times \begin{array}{c}\text{Total}\\\text{Interest}\\\text{Expense}\\\text{Affiliated}\\\text{Group}\end{array} = \begin{array}{c}\text{Apportioned Interest}\\\text{Expense to Category}\end{array}$$

A taxpayer may elect to value assets on the basis of tax book value or fair market value (FMV). (For the California computation, CCR §24344(c)(6) requires that the value of assets be the federal tax book value. Therefore, there could be a federal/state difference in the calculation.) Under the asset method in the temporary regulations, interest expense is apportioned to the various statutory groupings based on the average total value of assets in each grouping for the taxable year.

For purposes of this computation, investment in 10% owned corporations not included in the consolidated federal return are stated at adjusted basis, plus(minus) any increases(decreases) in E&P accumulated while the taxpayer held the stock. (This is similar to the California rules for determining the value of stock or other equity investment in affiliated entities used in the formula for assigning interest to foreign investment.)

Domestic corporations must use the asset method to apportion interest expense. CFCs may generally use the asset method or a modified gross income method to apportion interest expense. If, however, for federal purposes the US affiliates elect to use the FMV method to value their assets, then the CFCs must use the asset method.

An average of values (book or market) will be computed for the taxable year on the basis of values of assets within each grouping at the beginning and end of the year, except where a substantial distortion of asset values would result. (TR §1.861-9T(g).)

Revenue Agent Report adjustments can affect the foreign investment interest offset calculation. Any federal adjustments that apply for California purposes should first be considered before determining the foreign investment interest offset.

14.4 PASS SCHEDULES

CONTENTS:

a. Introduction
b. Unassigned Total Assets
c. Averaged Unassigned Foreign Investment

a. Introduction

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

b. Unassigned Total Assets

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c. Averaged Unassigned Foreign Investment

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